WILSHIRE CONSULTING

EXPOSURE DRAFT

Permissible Equity Markets
Investment Analysis
January 2006
Executive Summary

Background

- The purpose of this annual report is to evaluate a market's ability to support institutional investment. It is not intended to assess the current attractiveness of any individual market; that decision is delegated to the appropriate investment manager.
- The permissible markets analysis is based on a seven-factor model defined by the Investment Committee of CalPERS. There are three country factors (Political Stability, Transparency, and Productive Labor Practices) and four market factors (Market Liquidity and Volatility, Market Regulation/Legal System/Investor protection, Capital Market Openness, and Settlement Proficiency/Transaction Costs).
- Based on the factor definitions, Wilshire utilized third party sources, approved by the CalPERS Investment Committee, that provided an evaluation of all or a specific part of a factor.
- The country factors are given a 50% weighting of the total score, while the remaining 50% weighting is given to the market factors. This weighting scheme was determined by the CalPERS Investment Committee. Each factor and its sub-factors are scored on a three-point scale, where a score of three is the highest.
- The 2006 analysis reflects two changes relating to scoring methodology that the CalPERS Investment Committee approved in 2005. The first change affects the macro- and sub-factors, while the second affects the total country scores. In the past, all of the macro- and sub-factors were evaluated on a whole-number rating scale, where a country was assigned scores of 1, 2, or 3. However, starting with the 2006 analysis, all of the macro- and sub-factors were evaluated on a 1-decimal place rating system, where a specific sub-factor for a country could be assigned a score of 3.0, 2.7, 2.5, etc. To implement this methodology change, Wilshire had to define more narrowly the scoring breakpoints for most macro- and sub-factors, while some factors were not affected. In addition, the country factors, which were originally rounded to 2 decimal places in previous reports, are now rounded to 1 decimal place.

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- The analysis reviews 27 countries: Argentina, Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Jordan, Malaysia, Mexico, Morocco, Pakistan, Peru, Philippines, Poland, Russia, South Africa, South Korea, Sri Lanka, Taiwan, Thailand, Turkey, and Venezuela.

Findings

- Information for the report continued to be readily available, and thus, the overall transparency regarding these markets continued to improve. In addition, the high profile of this report has helped the third-party sources better evaluate these markets, as representatives of many of the countries have been in direct contact with the third-party sources and have become more serious about cooperating with them. In addition, we have had more correspondence directly with the stock exchanges than we had in 2005.
- There continued to be an increase in taxes on capital gains in several of the markets. Although the increased taxes have a negative impact on the overall scores of these countries, this is a sign of the continued maturation of these emerging markets, as many of the developed markets charge these taxes.
- Generally countries' scores improved over the last five years. In the 2002 report, the final scoring ranged from a high of 2.63 out of a possible 3.00 to a low of 1.15. The 2006 scores ranged from a high of 2.7 to a low of 1.5.
- Of the 27 countries, 9 countries had higher scores, while 18 countries had lower scores. Pakistan and Egypt made the biggest improvement during the year, while India and Sri Lanka fell the most precipitously.
- The impact of the two scoring methodology changes was previewed in the 2005 report. The analysis showed that moving the macro- and sub-factors to a 1-decimal place rating scale had an average impact of -0.02 to a country's total score.
- CalPERS' experience with the restricted list of permissible countries, which went into effect April 1, 2002, can be reviewed for the period it has existed. As of April 2005, the permitted list excluded roughly 10% of the available market capitalization, and resulted in an over-weight to the more economically sensitive market sectors. Thus the current list of countries will have, and have had, greater sensitivity to stock market swings.
- From April 1, 2002 to December 31, 2005, the Custom CalPERS FTSE All Emerging Markets Index underperformed the Standard FTSE Index by 2.2% on an annualized basis. In addition, this policy had an overall negative impact on actual performance. When comparing CalPERS' external emerging markets managers to each one's fully discretionary investment results on a gross-of-fees basis, CalPERS' actual performance was 2.1% lower than the fully discretionary results. However, the level of discrepancy in the manager performance has decreased over the last few years.

Conclusion

- The CalPERS Board previously included countries that score 2.00 or above. The 2.0 demarcation in 2006 would include 19 countries: Argentina, Brazil, Chile, Czech Republic, Hungary, India, Indonesia, Israel, Jordan, Malaysia, Mexico, Peru, the Philippines, Poland, South Africa, South Korea, Taiwan, Thailand, and Turkey. Sri Lanka fell below the threshold from the 2005 results and is eligible to be granted a one-year "cure period" to improve its score before excluding the country from the universe.